

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

77-6145

To be argued by
WILLIAM G. BALLAINE

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 77-6145

BERTHA LEMLE,

Plaintiff-Appellant,

—against—

UNITED STATES OF AMERICA,

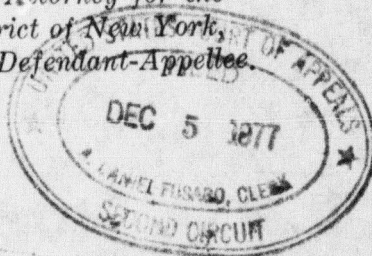
Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANT-APPELLEE

ROBERT B. FISKE, JR.,
*United States Attorney for the
Southern District of New York,
Attorney for Defendant-Appellee.*

WILLIAM G. BALLAINE,
PATRICK H. BARTH,
*Assistant United States Attorneys,
Of Counsel.*



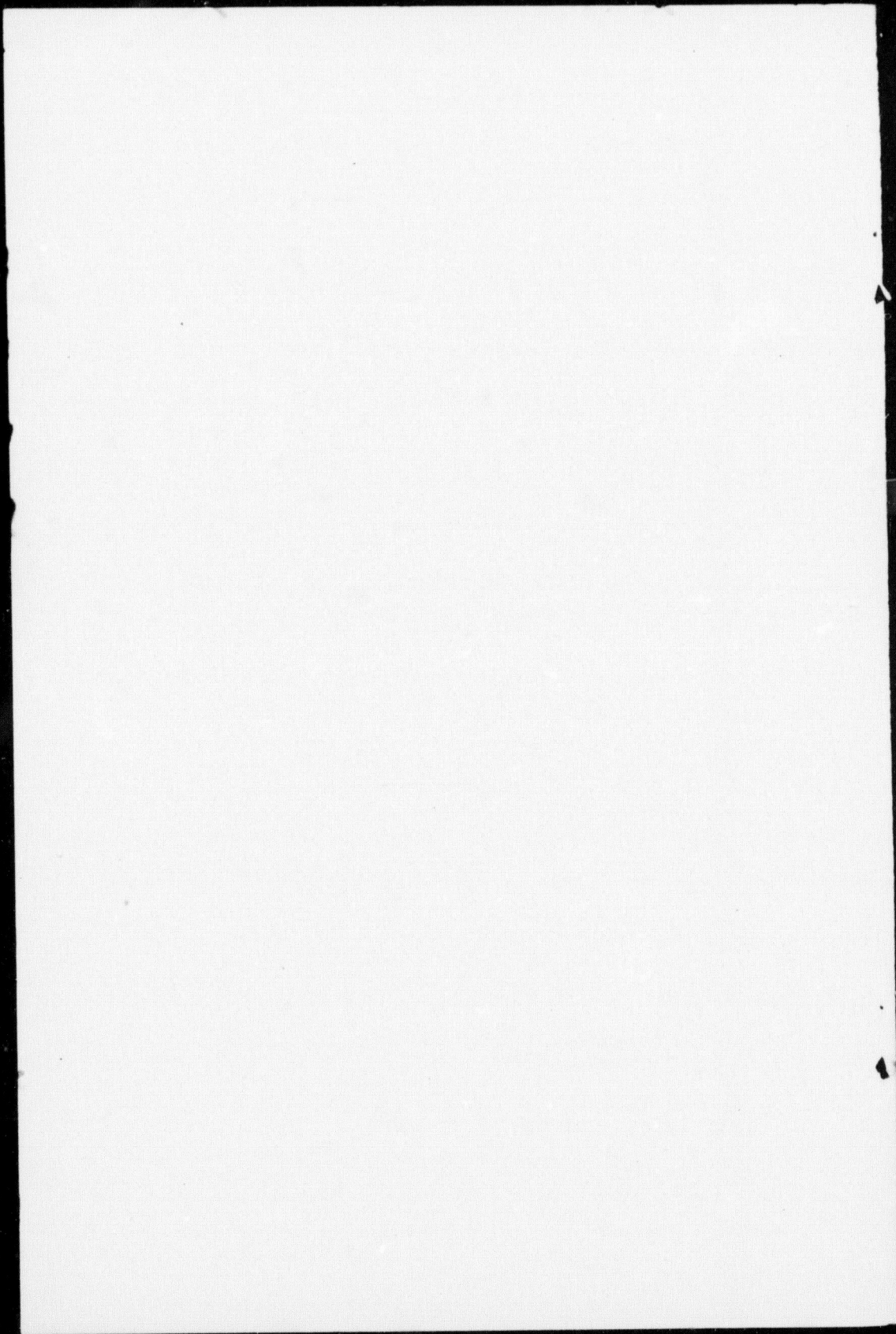


TABLE OF CONTENTS

	PAGE
Issue Presented	1
Statement of the Case	1
Proceedings Below	2
Statement of Facts	4
ARGUMENT:	
Taxpayer Failed to Prove That Her Distribu- tions Are Not Taxable Under The Code	7
I. Taxpayer Cannot Rely Upon the Settle- ment Agreements	7
IIa. The Operation of Sections 661-663	11
b. The District Court's Application of Sec- tions 661-663	13
c. Section 662 Applies to Principal Distribu- tions	15
d. Taxpayer's Distributions are not Ex- cluded by Section 663	17
e. Taxpayer's Distributions May Constitu- tionally be Taxed Under Section 662 ...	21
CONCLUSION	28

TABLE OF AUTHORITIES

Cases:

<i>In re Aaronson's Estate</i> , 20 App. Div. 133, 246 N.Y.S. 2d (2d Dep't 1963)	20
<i>Bohan v. United States</i> , 326 F. Supp. 1356 (W.D. Mo. 1971), <i>aff'd</i> , 456 F.2d 851 (8th Cir. 1972)	14

	PAGE
<i>Brushaber v. Union Pacific R.R.</i> , 240 U.S. 1 (1916)	24
<i>Commissioner v. Glenshaw Glass Co.</i> , 348 U.S. 426 (1955)	22, 27
<i>Commissioner v. South Texas Lumber Co.</i> , 333 U.S. 496 (1948)	18
<i>DeLorenzo v. United States</i> , 555 F.2d 27 (2d Cir. 1977)	15
<i>Eisner v. Macomber</i> , 252 U.S. 189 (1920)	22, 27
<i>Ellis v. United States</i> , 416 F.2d 82 (6th Cir. 1969)	23
<i>Elrick v. Commissioner</i> , 485 F.2d 1043 (D.C. Cir. 1973)	8, 9, 11
<i>Estate of Lawrence R. McCoy v. Commissioner</i> , 50 T.C. 562 (1968), <i>acquiesced</i> , 1973-2 Cum. Bull. 2	21
<i>Federal Bulk Carriers, Inc. v. Commissioner</i> , 558 F.2d 128 (2d Cir. 1977)	18
<i>Fernandez v. Wiener</i> , 326 U.S. 340 (1945)	24
<i>First National Bank v. United States</i> , 420 F.2d 725 (Ct. Cl.), <i>cert. denied</i> , 398 U.S. 950 (1970)	24
<i>Gregory v. Helvering</i> , 293 U.S. 465 (1935)	11
<i>Harkness v. United States</i> , 469 F.2d 310 (Ct. Cl.), <i>cert. denied</i> , 414 U.S. 820 (1973)	13, 15, 25, 27
<i>Harte v. United States</i> , 252 F.2d 259 (2d Cir. 1958)	7, 8
<i>In re Holloway's Estate</i> , 68 Misc. 2d 361, 327 N.Y.S. 2d 865 (Sur. Ct. 1972)	16
<i>James v. United States</i> , 366 U.S. 213 (1961)	22, 27
<i>Knowlton v. Moore</i> , 178 U.S. 41 (1900)	24
<i>Lemle v. United States</i> , 1975-1 USTC ¶9355 (S.D. N.Y. March 31, 1975)	2, 8
<i>Lemle v. United States</i> , 419 F. Supp. 68 (S.D.N.Y. 1977)	3, 4, 14, 20

	PAGE
<i>Lyeth v. Hoey</i> , 305 U.S. 188 (1938)	7, 8, 10
<i>Mahana v. United States</i> , 88 F. Supp. 285 (Ct. Cl.), cert. denied, 339 U.S. 978 (1950)	23
<i>Mott v. United States</i> , 462 F.2d 512 (Ct. Cl. 1972), cert. denied, 409 U.S. 1108 (1973)	12
<i>Neeman v. Commissioner</i> , 26 T.C. 864 (1956), <i>aff'd</i> <i>per curiam</i> , 255 F.2d 841 (2d Cir.), cert. denied, 358 U.S. 841 (1958)	22, 23
<i>Nicol v. Ames</i> , 173 U.S. 509 (1899)	21
<i>Scholey v. Rew</i> , 90 U.S. 331 (1874)	24
<i>Simmons v. United States</i> , 308 F.2d 160 (4th Cir. 1962)	24, 25, 27
<i>United States v. Bank of America National Trust &</i> <i>Savings Association</i> , 326 F.2d 51 (9th Cir. 1963) ..	13
<i>United States v. Janis</i> , 428 U.S. 433 (1976)	15
<i>Waller v. Commissioner</i> , 39 T.C. 665 (1963) ..	24, 25, 27
<i>United States Constitution:</i>	
U.S. Constitution, Art. I, § 8, cl. 1	24
U.S. Constitution, Amend. XVI	21, 24, 25, 27
<i>Federal Statutes:</i>	
26 U.S.C. § 61	22
26 U.S.C. § 71(a)	22, 23
26 U.S.C. § 72	24
26 U.S.C. § 74	24
26 U.S.C. § 102	11
26 U.S.C. § 102(a)	11
26 U.S.C. § 102(b)	11
26 U.S.C. § 102(b) (2)	11
26 U.S.C. § 643	12

	PAGE
26 U.S.C. § 652(b)	23
26 U.S.C. § 661	2, 3, 11, 21, 23, 25, 26
26 U.S.C. § 661(a)	13
26 U.S.C. § 661(a)(1)	12
26 U.S.C. § 661(a)(2)	12, 13, 21
26 U.S.C. § 662	2, 3, 11, 15, 16, 21, 23, 25, 26, 27
26 U.S.C. § 662(a)	17
26 U.S.C. § 662(a)(1)	12
26 U.S.C. § 662(a)(2)	12, 13, 15, 21, 27
26 U.S.C. § 662(b)	23
26 U.S.C. § 663	2, 3, 11, 13, 17, 18, 20, 25, 26
26 U.S.C. § 663(a)(1)	13, 14, 17, 18, 19, 20, 21
26 U.S.C. § 682(b)	23
26 U.S.C. § 2056	10
28 U.S.C. § 1346(a)(1)	1

Federal Regulations:

Treas. Reg. § 1.102-1(d)	11
Treas. Reg. § 1.661(a)-2(c)	13
Treas. Reg. § 1.661(a)-2(e) (rescinded) reprinted in 4 CCH 1964 Stand. Fed. Tax Rep. ¶ 3647	20
Treas. Reg. § 1.661(a)-2(e)	21
Treas. Reg. § 1.662(a)-3(b)	13, 15
Treas. Reg. § 1.663(a)-1(b)(1)	13, 14, 17, 18, 19, 20, 21
Treas. Reg. § 1.663(a)-1(c)(1)(iii)	18
Treas. Reg. § 1.663(a)-1(c)(1)(iv)	17

Federal Rules:

Rule 4(a), Federal Rules of Appellate Procedure . . .	3
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IRS Rulings and Decisions:

Revenue Ruling 57-214, 1957-1 Cum. Bull. 203 . . .	20
Revenue Ruling 64-101, 1964-1 Cum. Bull. 77 . . .	20, 21
T.D. 7287, 1973-2 Cum. Bull. 210	21

Legislative History:

S. Rep. No. 1622, 83d Cong., 2d Sess. (1954), re- printed in [1954] U.S. Code Cong. & Ad. News 4621	15, 18
H. Rep. No. 1337, 83d Cong., 2d Sess. (1954), re- printed in [1954] U.S. Code Cong. & Ad. News 4017	18

State Statutes:

N.Y. Decedent Estate Law § 18-d (repealed 1966) . .	4
N.Y. Estates, Powers and Trusts Law § 5-1.1 . . .	4

Other Authorities:

6 Mertens, Law of Federal Income Taxation §§ 36.72, 36.76-77 (rev. ed. 1975)	13, 15, 16
Parr, <i>Distributions by Estates</i> , 107 Trusts & Estates 97 (1968)	16



**United States Court of Appeals
FOR THE SECOND CIRCUIT**

Docket No. 77-6145

BERTHA LEMLE,
Plaintiff-Appellant,
—against—

UNITED STATES OF AMERICA,
Defendant-Appellee.

BRIEF OF DEFENDANT-APPELLEE

Issue Presented

Did the District Court err in concluding that plaintiff-appellant had failed to prove that the distributions received by her in 1965, 1966 and 1967 were not subject to any income tax under the Internal Revenue Code of 1954, as amended?

Statement of the Case

This is an appeal by plaintiff-appellant Bertha Lemle (the "taxpayer") from a judgment dismissing her tax refund suit against the United States of America. JA—157.* In her suit, commenced pursuant to 28 U.S.C. § 1346(a)(1), taxpayer seeks a refund of federal income taxes for the years 1965, 1966 and 1967 in the amounts

* "JA—" refers to the Joint Appendix filed by the parties.

of \$6,267.71, \$8,097.54 and \$6,705.69, respectively. JA—4-10.

Proceedings Below.

The District Court, by the Honorable William C. Conner, rendered four opinions in this action. The first opinion, dated March 31, 1975, disposed of cross-motions for summary judgment made by the taxpayer and the United States. JA—111-21.* Judge Conner held that the taxpayer could assert a settlement reached in 1971 between her and the estate of her late husband as the basis for her claim to a refund of federal income taxes paid on sums distributed to her by the estate in 1965, 1966 and 1967. Under the settlement, these distributions were described as principal distributions. For tax purposes, however, the Internal Revenue Service ("IRS") had treated the distributions as income distributions, as had the estate when it made the distributions to the taxpayer during the tax years. The District Court denied taxpayer's summary judgment motion solely on the ground that there remained an unresolved factual issue as to whether taxpayer had entered into the settlement in good faith. JA—120.

Thereafter, the United States conceded that it had no additional evidence to submit on the good faith issue, but claimed that on the existing record taxpayer was not entitled to the full refund claimed because of the operation of Sections 661-663 of the Internal Revenue Code of 1954, as amended (hereinafter the "Code"), 26 U.S.C. §§ 661-663. Judge Conner then issued a second opinion, dated February 3, 1976, concluding that this argument raised "a potentially critical legal impediment" which required full briefing and review. JA—122-30.

* This opinion is reported in 1975-1 USTC ¶ 9355.

In its third opinion, dated September 2, 1976, the District Court concluded that Sections 661-663 of the Code made the distributions in issue potentially subject to tax, regardless of how the distributions were described in taxpayer's settlement agreement. JA—135-48.* The District Court held that it was, accordingly, without relevant evidence needed to gauge the precise refund to which the taxpayer might be entitled, adding that the burden of proof was on the taxpayer, not the United States. JA—147-48.

Taxpayer waived her right to offer evidence on the factual issues described in the third opinion and, instead, asked the Court to reverse its legal conclusion. In its last opinion, dated June 27, 1977, the District Court once again rejected taxpayer's unswerving claim to a full refund on the existing record. JA—151-56. Since taxpayer had advised the District Court that she wished to rest her case on the merits, without a trial, Judge Conner held that she had not met her burden of proof. Judge Conner, therefore, directed that judgment be entered dismissing the complaint. JA—156.** On June 29, 1977 judgment was entered and taxpayer thereafter appealed. JA—157-60.***

* The third opinion is reported in 419 F. Supp. 68.

** In taxpayer's brief on appeal, she erroneously states that the District Court "granted summary judgment dismissing her complaint." Appellant's Brief (hereinafter "App. Br.") 1. As Judge Conner's last opinion reflects (JA—156), the judgment was entered because plaintiff stated for the record that she did not wish to adduce further evidence either by stipulated submission or at a trial.

*** Taxpayer filed her notice of appeal on September 1, 1977. JA—158. Since this filing was untimely, the District Court thereafter signed an unopposed order, pursuant to Rule 4(a) of the Federal Rules of Appellate Procedure, appropriately extending her time to file a notice of appeal. JA—159-60.

Statement of Facts

Taxpayer is the widow of Julius Lemle, who died on December 8, 1964. Julius Lemle's last will and testament and a first codicil thereto (hereinafter the "will") was admitted to probate in New York Surrogate's Court, New York County and letters testamentary were issued to taxpayer and three others as co-executors of the estate. JA—60-61, 80, 97.

Under the will, taxpayer was to receive, *inter alia*, the net income for life of one-third of her late husband's residuary estate, with a proviso that she receive \$700 per month as minimum income. JA—61, 80, 97.* Pursuant to this direction, the co-executors of the estate began in 1965 to make distributions of income to taxpayer. JA—27-28, 80-81, 97, 101. Taxpayer retained the 1965 distribution of income, but, through her legal counsel, advised attorneys representing the estate of her contention that the "payment is made to her on account of the monies she will ultimately be entitled to receive out of the estate, whether by way of principal or income." JA—27-28.

On February 3, 1966, taxpayer filed a notice of election in New York Surrogate's Court, pursuant to former Section 18-d of New York's Decedent Estate Law (presently Section 5-1.1 of the New York's Estates, Powers and Trusts Law), claiming that her late husband's will provided less than her elective share. JA—61, 80, 97.

* The will provided for the creation of a trust out of which these income payments were to be made. JA—33-43, 80, 97, 131-32. Although it does not appear in the record on appeal, taxpayer's counsel has advised that, because of taxpayer's litigation, the trust was not funded. The record's failure to reflect this fact does not affect the case at bar, as the District Court noted in footnote 8 to its third opinion. JA—150; 419 F. Supp. at 73, n.8.

If valid, taxpayer's claim would have entitled her to one-third of her late husband's adjusted gross estate, including one-third of all income received by the estate and one-third of all appreciation in the value of the estate's assets after decedent's death. JA—53. The executors of the will, other than taxpayer, rejected the widow's claimed right of election, and litigation ensued. JA—62, 80, 97.

During the litigation, the estate continued to send taxpayer income distributions under the will. Taxpayer claimed that these distributions also were being accepted by her as part of her claimed elective share (JA—27-30, 80-81, 97), and for each of the three tax years in issue, taxpayer filed federal income tax returns treating the estate's distributions as payments of principal allegedly excludable from gross income. JA—22, 33-43.

Upon audit by the IRS, income tax deficiencies were assessed against taxpayer for 1965, 1966 and 1967, representing income tax on the estate's distributions. JA—81, 98. The assessed deficiencies were paid by plaintiff in August, 1969 and taxpayer then filed claims for refund. JA—81, 82, 98.

On April 7, 1971, four to six years after the distributions had been made, the Surrogate's Court signed a decree approving agreements that settled taxpayer's disputed right to an elective share. JA—44-48, 82, 99. One of the agreements stated that taxpayer would accept, in full satisfaction of her rights, the sum of \$453,712.25, "payable out of the principal of [the] estate as hereinafter provided." JA—66, 81, 98-99. This agreement then specified that the \$216,974.86 in income distributions paid to taxpayer by the estate between 1965 and 1970, including the 1965-1967 distributions, would be treated as part payment of the total settlement amount and that the remaining amount due would be paid in three separate

lump sums, each payable within 60 days after entry of the Surrogate's Court decree. JA—67-68, 98-99. IRS officials were informed of the existence of taxpayer's litigation (JA—94), but the United States of America was not a party to the compromise agreements nor to the Surrogate's Court proceeding (JA—99).

After entry of the April, 1971 Surrogate's Court decree, the settlement documents were sent to the IRS examiner responsible for reviewing taxpayer's refund claims for 1965, 1966 and 1967. The examiner was prepared to approve the taxpayer's refund claims because it had been represented to him that beneficiaries other than taxpayer would file amended returns in order to report and pay taxes on all income distributions previously charged to taxpayer. JA—95, 100, 108-09. As the District Court's first opinion points out (JA—114-15), however, no final approval was given. JA—6, 14, 95, 108-09.* Instead, the matter was reviewed by the examiner's supervisors, who suggested that final allowance be withheld until the other beneficiaries actually took the steps proposed. JA—100, 107-09. Since there was a distinct possibility that the statute of limitations would bar assessment of additional taxes against these other beneficiaries, the IRS officials realized that the federal tax interest could only be satisfied if the beneficiaries first filed amended returns and reported the distributions in issue as promised. JA—94-95, 107-08.

The IRS's decision to withhold approval proved to be well-advised. It appears the other beneficiaries never did file amended returns or pay additional taxes, as it had been represented they would. JA—95, 100, 108-09. There

* Taxpayer erroneously states throughout her brief that her refund claims were allowed but that the IRS subsequently reversed its position. App. Br. 3, 9, 10.

is no indication in the record that taxpayer ever made any efforts to force the beneficiaries to file amended returns or pay additional taxes, and, as Judge Conner's third opinion notes (JA—146), the settlement agreements do not contain any provision requiring other beneficiaries to file amended returns or pay additional taxes. See JA—60-79.

ARGUMENT

Taxpayer Failed To Prove That Her Distributions Are Not Taxable Under The Code.

Taxpayer's claim to a full tax refund is premised on the two-pronged assertion that (1) by reason of the 1971 settlement she received distributions of principal and (2) such distributions cannot be subject to federal income tax. The Government submits that both prongs of her argument are fatally defective.

I. Taxpayer Cannot Rely Upon The Settlement Agreements.

Taxpayer's refund claim is based entirely on the statement in one of the settlement agreements that she was to be paid in settlement the sum of \$453,712.25 "payable out of the principal of [the] estate." JA—66. This settlement provision cannot be relied upon to satisfy taxpayer's burden of proving her right to a tax refund.

Taxpayer claims that her 1971 settlement must be applied in her favor in this refund suit because of *Lyeth v. Hoey*, 305 U.S. 188 (1938) and *Harte v. United States*, 252 F.2d 259 (2d Cir. 1958). App. Br. 13-18. In *Lyeth v. Hoey*, *supra*, however, the Court was simply called upon to determine the character of moneys paid to a taxpayer

as a direct result of his settlement of a state court claim to additional sums as an heir of his grandmother's estate. The Supreme Court concluded that such settlement moneys must be given the same characterization as they would have received had the litigation been "fought to a finish," with the taxpayer prevailing. *Lyeth v. Hoey, supra*, 305 U.S. at 196. Similarly, in *Harte v. United States, supra*, this Court applied *Lyeth* by examining a settlement agreement entered into on behalf of the appellant in order to determine the nature of moneys actually paid to appellant out of a trust fund set up under the settlement.

In the present case, unlike *Lyeth*, *Harte* or any of the other cases cited by the District Court in its first opinion, the taxpayer did not receive her distributions as a result of the subsequent settlement. Quite the contrary, as the District Court pointed out in its third opinion, the distributions in issue were properly made to taxpayer regardless of the outcome of her lawsuit. JA—144; 419 F. Supp. at 72. Thus, *Lyeth* and its progeny are not at all controlling in taxpayer's favor in this case.

Although the District Court rejected the Government's distinction of *Lyeth v. Hoey, supra*, it did conclude that taxpayer's right to recover was predicated on a factual determination as to the *bona fides* of the settlement. JA—120; 75-1 USTC at p. 86, 852. But Judge Conner's decision suggested that the issue would be whether the overall settlement of taxpayer's elective share claim was entered into in good faith. The Government submits, however, that the critical issue in this case is far narrower—it is whether the "agreement" that taxpayer's distributions were of principal is borne out by the realities of taxpayer's transactions with the estate.

In *Elrick v. Commissioner*, 485 F.2d 1049, 1054 (D.C. Cir. 1973), the Court of Appeals for the District of Columbia emphasized:

that this court will not be bound by the parties' self-serving characterization of the settled claim.

That is, we are concerned that the Tax Court seemed to feel that merely by labeling her cause of action one for "quasi-specific performance of a contract to make a will," taxpayer managed to foreclose all inquiry into the true nature of her claim. This would be the ultimate perversion of the *Lyeth* rationale. *Lyeth* holds that it is the realities of the claim that control the characterization of the subsequent compromise or settlement, not the labels of the parties.

[footnote omitted]

Elrick v. Commissioner, supra, 485 F.2d at 1054. The Government submits that this reasoning not only precluded summary judgment in taxpayer's favor, as the District Court held, it also compels the conclusion that taxpayer cannot meet her burden of proof by relying upon the language of the settlement agreements.

The undisputed facts are that taxpayer was paid income, not principal, in 1965, 1966, and 1967. If she had prevailed in her lawsuit, she would have been entitled to both principal and income (JA—27-30, 53, 61, 80-81, 90). One of the settlement agreements stated that taxpayer's settlement was "payable out of principal", but, in substance, it simply credited the income distributions previously made to her against her total settlement amount. JA—66-67. None of the settlement agreements indicated who, if anyone, would be treated as having received the income previously paid to taxpayer and credited against her total settlement amount. JA—146; 419 F. Supp. at 73 and n. 7. Although representations have been made that, under the settlement, other beneficiaries were to report the income previously paid to the taxpayer (JA—55, 94-95, 99-100), no such action was ever taken (JA—95, 99) so that, in substance, no taxpayer has claimed

actual or constructive receipt of the estate-generated income paid to the taxpayer in 1965, 1966 and 1967.

Although no party has conceded that it is chargeable with the income paid to the taxpayer, the parties to the settlement eagerly embraced the settlement's statement that taxpayer's distributions would be considered principal, not income. When the parties petitioned the Surrogate's Court to approve the settlement, they emphasized that the estate would be entitled to a marital deduction for the full amount of the settlement (JA—53), an entitlement which had to be predicated on the parties' "agreement" that none of the settlement amount was being paid out of the estate's income; see 26 U.S.C. § 2056. Thus, simply by referring to moneys already paid out to the taxpayer as principal, the estate expected to get a substantial marital deduction not previously available. Taxpayer, too, was presumably pleased with this drafting achievement because she assumed, wrongly, that this simple act of drafting would now solidify her tax refund claims.

These facts demonstrate that, although taxpayer's claim to an elective share was no doubt *bona fide*, the parties' attempted recharacterization of the distributions in issue was not. On the existing record, this recharacterization was an exercise of form over substance, serving only one purpose—to give both the estate and the taxpayer federal tax benefits without shifting the tax burden for the estate's income to any other parties. The Government submits that the taxpayer's attempt to rely upon such a recharacterization finds no support in the holding or rationale of *Lyeth v. Hoey*, *supra*. Moreover, it is con-

trary to the teaching of *Elrick v. Commissioner, supra*; and it is at odds with the well-settled principle that the tax laws are concerned with the substance of a transaction, not its form, *Gregory v. Helvering*, 293 U.S. 465, 470 (1935). Accordingly, taxpayer's reliance solely upon the characterization of her distributions in her 1971 settlement agreements should be rejected.

II a. The Operation of Sections 661-663.

Quite apart from whether taxpayer's distributions are properly considered as principal from the estate, her present refund claim fails for a second reason. Whether principal or income, the distributions are taxable under the operation of Sections 102(b)(2) and 661-663 of the Code.

Section 102 of the Code excludes from gross income the value of property acquired by gift, bequest, devise or inheritance, but does not exclude a gift, bequest, devise or inheritance of *income* from property. 26 U.S.C. § 102 (a) and (b). Section 102(b)(2) also directs that

Any amount included in the gross income of a beneficiary under subchapter J [Sections 641-692 of the Code] shall be treated . . . as a gift, bequest, devise or inheritance of income from property.

26 U.S.C. § 102(b)(2). See Treas. Reg. § 1.102-1(d).*

Sections 661-663 of subchapter J, 26 U.S.C. §§ 661-663, contain detailed rules for taxing income generated from property held by an estate or a trust. Through the operation of sections 661-663,

* The Treasury Regulations are printed in volume 26 of the Code of Federal Regulations.

Congress has adopted the "conduit principle" of taxing estates (and trusts as well), through which an estate is treated as a taxable entity and is taxed, in general, on income which it realizes but which it does not distribute, or is not deemed to have distributed, to its beneficiaries. *Where income is distributed to a beneficiary, or is deemed to be so distributed, that income would not be taxable to the estate but instead would be taxable to the beneficiary*, a result which is accomplished by permitting the estate a deduction for the amount of the distribution and by requiring the beneficiary to include that amount in his gross income.

[emphasis added]

Mott v. United States, 462 F.2d 512, 514 (Ct. Cl. 1972), cert. denied, 409 U.S. 1108 (1973).

Section 661(a)(1) of the Code permits the estate to deduct from its gross income any estate "income . . . required to be distributed currently" for a taxable year up to but not exceeding the estate's distributable net income, as that phrase is defined in section 643, 26 U.S.C. § 643. The section 661(a)(1) amounts of income "required to be distributed currently" are commonly referred to as first tier amounts. Under Section 662(a)(1), beneficiaries of the first tier amounts for which the estate receives a deduction must include the amounts in their gross income for the tax year.

If the total of the estate's first tier amounts for a tax year does not equal or exceed the estate's distributable net income, then the estate, under section 661(a)(2), also may deduct "*all other amounts properly paid, credited or required to be distributed for [the] taxable year*" [emphasis added], still subject to the distributable net income ceiling. Once again, section 662(a)(2) taxes beneficiaries on these amounts, called second tier amounts, for which the estate obtained a deduction. Sections 661

(a) (2) and 662(a) (2) encompass *all* amounts, whether income or principal, that are "properly paid, credited, or required to be distributed" to the beneficiaries. *E.g.*, *United States v. Bank of America Nat'l Trust & Savings Association*, 326 F.2d 51, 54 (9th Cir. 1963); *Harkness v. United States*, 469 F.2d 310, 315-16 (Ct. Cl. 1973), *cert. denied*, 424 U.S. 820 (1973); Treas. Reg. §§ 1.661(a)-2(c) and 1.662(a)-3(b); 6 Mertens, *Law of Federal Income Taxation*, §§ 36.72, 36.76-77 (rev. ed. 1975).

Section 663 of the Code specifically excludes certain second tier amounts from the operation of sections 661(a) (2) and 662(a) (2), but it is narrowly limited to an amount

which under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments.

26 U.S.C. § 663(a) (1). Moreover, Treas. Reg. § 1.663(a)-1(b) (1) clarifies the "specific sum of money" requirement, stating that

In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or of specific property must be ascertainable under the terms of a testator's will as of the date of his death.

II b. The District Court's Application Of Sections 661-663.

In the instant action, the District Court properly determined that taxpayer's distributions fell within the embrace of section 662(a) (2) as second tier amounts "properly paid, credited or required to be distributed" by

the estate. JA-142-47; 419 F. Supp. at 71-73.* The District Court noted that despite taxpayer's litigation, there never was any dispute as to whether these distributions were properly paid by the estate. The only issue was whether the distributions were payable under the will or by reason of her claimed elective share. JA-142-44; 419 F. Supp. at 71-72. In addition, Judge Conner concluded that if, as taxpayer claimed, the 1971 settlement supplied the proper basis for determining, *nunc pro tunc*, that the 1965-1967 payments were distributions of principal by the estate, it must also be viewed as retroactively validating the action of the estate in making those distributions to her. JA-143-44; 419 F. Supp. at 72.

The District Court also rejected taxpayer's claim to the exclusionary benefits of section 663(a)(1) because of the Treas. Reg. § 1.663(a)-1(b)(1) requirement that the amount of the bequest be ascertainable as of the decedent's date of death. Judge Conner observed that the \$453,712.25 "bequest" relied upon by taxpayer was a compromise of the value of her claim to one-third of the entire estate reached some six years after her husband had died. As such, the settlement obviously was not a bequest of a specified sum ascertainable as of her husband's date of death. JA-154-56.

Based upon its analysis, the District Court had no choice but to dismiss taxpayer's refund suit for lack of proof. Taxpayer chose not to adduce evidence of the estate's total amount of distributable net income or the total sum of first tier amounts received by beneficiaries of the estate for 1965, 1966 or 1967. As a result, the

* Compare *Bohan v. United States*, 326 F. Supp. 1356 (W.D. Mo. 1971), *aff'd*, 456 F.2d 851 (8th Cir. 1972). On this appeal taxpayer's brief does not dispute the District Court's determination that the distributions were "properly paid, credited or required to be distributed."

District Court lacked any evidence to establish that the distributions to plaintiff—as second tier amounts—would not be taxed under Section 662(a)(2) of the Code. Since taxpayer, not the United States, bore the burden of proving the amount of tax refund to which she is entitled, *United States v. Janis*, 428 U.S. 433, 440 (1976), *De Lorenzo v. United States*, 555 F.2d 27, 29 (1977), taxpayer's refusal to submit further evidence mandated dismissal.*

II c. Section 662 Applies To Principal Distributions.

Taxpayer seems to challenge the District Court's holdings on three grounds. First, taxpayer states that the subchapter J mechanism in issue "necessarily assumes that the beneficiaries are entitled to income" (App. Br. 20a), implying that section 662 cannot be construed to impose a tax upon a beneficiary of principal only. See App. Br. 19-24. Taxpayer's contention, however, is not supported by the language of section 662(a)(2), which broadly encompasses "*any other amounts properly paid or credited or required to be distributed*" [emphasis added]. 26 U.S.C. § 662(a)(2). More important, taxpayer's contention is refuted by case law, *e.g.*, *Harkness v. United States*, *supra*, 469 F.2d at 315-16, by applicable Treasury Regulations, *e.g.*, Treas. Reg. § 1.662(a)-3(b), by authorities in the field, *e.g.*, 6 Mertens, *supra*, § 36.76, and by legislative history, *e.g.*, S. Rep. No. 1622, 8d Cong., 2d Sess. (1954), reprinted in [1954] U.S. Code Cong. & Ad. News 4621, 4989-91. Thus, one authority describes the operation of Sections 661 and 662 as follows:

* Taxpayer's decision not to introduce evidence concerning the estate's distributable net income or the estate's first tier amounts for 1965, 1966 or 1967 suggests that, in fact, her second tier amounts are taxable in full, thus defeating her present claims in their entirety.

This statutory tier system can lead to quite different results than obtained under the tier system of the prior statute. For example, if the fiduciary should pay equal amounts to two beneficiaries, *one of whom is entitled only to corpus* and the other of whom is entitled to either income or corpus, *taxability is shared equally by the two beneficiaries. . . . In other words, the distinction between corpus and income distributions which was observed under prior law is largely obliterated by the approach taken in the present statute.* [emphasis added; footnotes omitted].

6 Mertens, *supra*, § 36.76 at pp. 181-82.*

In summary taxpayer's first contention plainly lacks merit. Section 662, on its face and as interpreted by case law, Treasury Regulations, authorities in the field and legislative history, may operate to require the taxpayer to share the burden of an income tax on the distributions properly paid to her in 1965, 1966 and 1967.

* Taxpayer's own citations to case law and authorities support the Government's position that principal is subject to tax under section 662. See *In re Holloway's Estate*, 68 Misc. 2d 361, 327 N.Y.S. 2d 865, 866 (Sur. Ct., 1972) [quoted at App. Br. 19]; and Parr, *Distributions by Estates*, 107 Trusts & Estates 97 (1968) [quoted at App. Br. 23]. Moreover, with respect to legislative history, taxpayer admits that "there is no reference to any purpose to include principal distributions in taxable income *except to the extent of a presumption that all distributions, to the extent of the available income, shall be deemed income*" [emphasis added]. App. Br. 21.

II d. Taxpayer's Distributions Are Not Excluded By Section 663.

Taxpayer's second contention is that her settlement payments are expressly excluded from tax by reason of Section 663 of the Code. *See* App. Br. 24-33. Taxpayer also insists that the District Court erred in relying upon the Treas. Reg. § 1.663(a)-1(b)(1) requirement that a bequest of a specific sum of money, to be excluded from the operation of section 662(a), must be ascertainable as of the date of a testator's death. Taxpayer's analysis of both section 663 and Treas. Reg. § 1.663(a)-1(b)(1) is defective.

Although she claims exclusion under section 663(a)(1), taxpayer never indicates how she proposes to satisfy its specific requirement that the bequest be "paid or credited all at once or in not more than 3 installments." 26 U.S.C. § 663(a)(1). Taxpayer's total settlement was paid through distributions made over the course of five years, from 1965 to 1970, and through three additional installment payments directed to be made after entry of the Surrogate's Court decree. These payout terms obviously do not meet the three installment requirement of section 663(a)(1).^{*} Having voluntarily entered into the

^{*} In order to satisfy the three installment requirement taxpayer must make two arguments. If either fails, she cannot meet the requirement at all. In fact, both arguments are defective. She must argue first that all of the distributions made between 1965 and 1970 constituted a single installment payment. Taxpayer then must argue that the three installment payments to be made within 60 days of entry of the Surrogate's Court order also should be considered as one installment. The fallacy of the first argument is discussed at p. 19, *infra*. The second argument requires taxpayer to ignore her own settlement documents, which separately designated three lump sum payments to be made to her within the same time frame, but certainly not at the same time. *Compare* Treas. Reg. § 1.663(a)-1(c)(1)(iv).

[Footnote continued on following page]

settlement agreements, taxpayer now must be bound by their plain terms for tax purposes. *Cf.*, *Federal Bulk Carriers, Inc. v. Commissioner*, 558 F.2d 128, 130 (2d Cir. 1977).

Taxpayer's claim to a section 663(a)(1) exclusion also is foreclosed, as Judge Conner held, by the Treas. Reg. § 1.663(a)-1(b)(1) requirement that the "bequest" be ascertainable as of the testator's death. This Regulation, unless unreasonable and plainly inconsistent with the revenue statutes, must be sustained. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948).*

Taxpayer seeks to meet the requirement of Treas. Reg. § 1.663(a)-1(b)(1) by drawing upon the claimed retroactivity of her 1971 settlement. She argues, in effect, that her right to a lump sum of \$453,712.25 should be deemed to have accrued as of her late husband's death. This proposed fiction must be rejected.

It is one thing for a taxpayer to argue that a bequest such as a partnership interest is excludable under section 663(a)(1). *See* Treas. Reg. § 1.663(a)-1(b)(1). There,

On this appeal, taxpayer does not try to claim, nor can she claim, the benefits of Treas. Reg. § 1.663(a)-1(c)(1)(iii), which states that gifts and bequests "*under a decedent's will...for which no time of payment or crediting is specified*" are considered as required to be paid in a single installment [emphasis added].

* Taxpayer's brief (App. Br. 33) implies that Treas. Reg. § 1.663(a)-1(b)(1) might be unreasonable because it seems to foreclose settlements of will contests from falling within the exclusionary embrace of section 663. However, legislative history indicates that when Congress referred to a "governing instrument" in section 663(a)(1) it had in mind wills and trust instruments; Congress did not seem to give any consideration to settlement instruments prepared and executed subsequent to the testator's death. *See, e.g.*, S. Rep. No. 1622, 83d Cong., 2d Sess., (1954) reprinted in [1954] U.S. Code Cong. & Ad. News 4621, 4994-96; H. Rep. No. 1337, 83d Cong., 2d Sess., (1954), reprinted in [1954] U.S. Code Cong. & Ad. News 4017, 4344.

although the amount of the bequest may not be ascertained immediately by the parties, the actual amount is immediately *ascertainable*, as the Regulation requires, because the pertinent facts are available as of the decedent's death. The present taxpayer's case, however, differs from the situation just described in one critical respect. Here an essential fact was not known as a decedent's death *and was not ascertainable* until some six years later, specifically: on what terms would taxpayer and the estate finally agree to compromise her claim to a full elective share? The fact that the amount of taxpayer's settlement was not ascertainable when her late husband died makes it impossible for taxpayer to satisfy Treas. Reg. § 1.663(a)-1(b)(1).

Even if this Court were to accept taxpayer's fiction that her settlement sum was ascertainable as of her late husband's death, taxpayer must still lose. In this action, taxpayer is forced to vacillate wildly in her retroactive application of the 1971 settlement. She must argue for retroactivity when facing the Treas. Reg. § 1.663(a)-1(b)(1) requirement just discussed, but ignore retroactivity when trying to satisfy the section 663(a)(1) three installment rule. Thus, she claims that she received separate distributions in 1965, 1966 and 1967, which were "deemed" to have been principal payments by reason of the retroactive feature of the 1971 settlement; she also wants her total settlement amount treated, *nunc pro tunc*, as though it were ascertainable as of her husband's death. Yet, for purposes of the three installment requirement, she asks this Court to pretend that the separate distributions in 1965-1967 were part of a single lump sum payment simply because they are referred to as part of a single total sum in the 1971 settlement agreements. Taxpayer cannot have it both ways. If her retroactivity argument helps her surmount the requirement of Treas. Reg. § 1.663(a)-1(b)(1), then she cannot also satisfy the three installment rule.

In claiming the benefits of Section 663, taxpayer cites as authority in her favor two Revenue Rulings, Rev. Rul. 57-214, 1957-1 Cum. Bull. 203 and Rev. Rul. 64-101, 1964-1 Cum. Bull. 77. Neither Ruling, however, aids the taxpayer.

Revenue Ruling 57-214 simply states that the funding of a trust constitutes a payment of a specific sum of money within the meaning of section 663(a)(1). However, the Ruling contains no facts indicating that it might help taxpayer avoid the section 663(a)(1) three installment rule. Nor does the Ruling bear on the Treas. Reg. § 1.663(a)-1(b)(1) requirement at issue here.

Similarly, Revenue Ruling 64-101 offers taxpayer no comfort. That Ruling relies not on section 663, but on a Treasury Regulation that specifically and narrowly excluded from sections 661 and 662 a widow's dower interest (an allowance under local law for the support of a decedent's widow during administration of an estate). See Treas. Reg. § 1.661(a)-2(e) (rescinded) reprinted in 4 CCH 1964 Stand. Fed. Tax Rep. ¶ 3647. The Regulation's specific exclusion of a dower interest does not help taxpayer's case, which is based upon an entirely different interest—settlement of a claimed elective share. See JA-149; 419 F. Supp. at 71, n.5; cf., *In re Aaronson's Estate*, 20 App. Div. 2d 133, 246 N.Y.S. 2d 61 (2d Dep't 1963).*

* A lump sum bequest, to be excludable under section 663, must be in an amount ascertainable as of decedent's date of death. Treas. Reg. § 1.663(a)-1(b)(1). The dower interest in Revenue Ruling 64-101 may well have met this standard, since it was a fixed percentage of decedent's property as of death without regard to expenses of administration of the estate. Taxpayer's elective share, on the other hand, would have been computed as a percentage of an estate's adjusted gross estate (minus certain expenses of administration) including income generated by the estate and appreciation in the value of the estate's assets after decedent's death. JA-53. Obviously, these are items which could not have been determined until after death.

In addition, the Tax Court has since declared invalid the Treasury Regulation upon which Revenue Ruling 64-101 is based. The Tax Court concluded that the Regulation was inconsistent with the "plain wording" of section 661(a)(2), insofar as this section broadly encompassed "any other amounts properly paid, credited or required to be distributed." *Estate of Lawrence R. McCoy v. Commissioner*, 50 T.C. 562, 566-67 (1968), *acquiesced*, 73-2 Cum. Bull. 2. Since the *McCoy* decision, the Internal Revenue Service has rescinded the Treasury Regulation relied upon in Revenue Ruling 64-101 (see T.D. 7287, 1973-2 Cum. Bull. 210-11) in order to make clear that a dower interest does, in fact, come within the operation of sections 661 and 662 of the Code. See present Reg. § 1.661(a)-2(e).

In summary, the plain language of Section 663(a)(1) of the Code and Treas. Reg. § 1.663(a)-1(b)(1) preclude taxpayer from claiming exclusion from the operation of section 662(a)(2); and taxpayer has not pointed to any pertinent authority suggesting the contrary.

II e. Taxpayer's Distributions May Constitutionally Be Taxed Under Section 662.

As a third and final legal thrust, taxpayer briefly discusses the "effect" of the Sixteenth Amendment to the Constitution, intimating that this Amendment does not authorize the imposition of an income tax on her distributions. App. Br. 34. In making a constitutional argument, taxpayer must overcome a presumption of constitutional validity, one which is particularly strong in the case of a revenue measure. *Nicol v. Ames*, 173 U.S. 509, 514-15 (1899). As the sketchy nature of taxpayer's argument suggests, her constitutional assault cannot overcome this strong presumption.

The Sixteenth Amendment permits Congress to impose direct taxes on "income from whatever source de-

rived." In taxpayer's brief, she defines this term as it was first defined in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920), to cover only "the gain derived from capital, from labor, or from both combined." App. Br. 34. She ignores, however, *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), in which the Supreme Court stated that the *Eisner* definition "was not meant to provide a touchstone to all future gross income" and then concluded that "income" broadly embraces "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.*, 348 U.S. at 431; see *James v. United States*, 366 U.S. 213, 219 (1961).^{*} Here, taxpayer's distributions plainly were an "accession to [her] wealth."

Neeman v. Commissioner, 26 T.C. 864 (1956), *aff'd per curiam*, 255 F.2d 841 (2d Cir.), *cert. denied*, 358 U.S. 841 (1958), is instructive on this constitutional issue. In *Neeman*, a taxpayer challenged provisions in the Internal Revenue Code of 1939, as amended, that granted a tax deduction to a spouse making alimony payments and shifted the income tax burden to the spouse receiving the payments.^{**} Taxpayer insisted that the provisions were unconstitutional insofar as they taxed alimony payments made out of tax-exempt income. The Tax Court rejected this argument, concluding that the source of the payments was immaterial and that the test of constitutionality simply was whether the alimony was

^{*} *Glenshaw Glass* and *James* interpret the term "income" under Section 61 of the Code, not under the Sixteenth Amendment. However, the context of each case demonstrates that the Court was aware of the constitutional implications of the definition and that the scope of the term "income" under section 61 and the Sixteenth Amendment should be viewed as coterminous. See *Simmons v. United States*, 308 F.2d 160, 168 and n. 28 (4th Cir. 1962).

^{**} In the present Code, these alimony provisions appear in section 71(a), 26 U.S.C. §71(a).

"income" to the recipient. *Id.*, 26 T.C. at 868-69. *Neeman* was affirmed by this Court on the opinion below. *Id.*, 255 F.2d 841.*

The analysis in *Neeman* applies here with equal force. For constitutional purposes, it is irrelevant whether the actual source of taxpayer's distributions was income or principal of the estate. In either event, the distributions indisputably increased taxpayer's wealth. Thus, under the appropriate Supreme Court definition of the term, these distributions were "income" properly taxable by Congressional enactment.**

* Compare *Ellis v. United States*, 366 F.2d 894 (6th Cir. 1969). In *Ellis* the Sixth Circuit Court of Appeals acknowledged that alimony payments made from an alimony trust are includable in the recipient's gross income regardless of whether the payments are from income or corpus of the trust because that was the clear intent of the applicable statute. *Id.*, 416 F.2d at 897. *Ellis*, however, refused to accept *Neeman's* conclusion that the source of a payment is immaterial for purposes of construing the statutory interplay of Sections 71(a), 652(b), 662(b) and 682(b) of the Code. The Court therefore rejected the Government's argument that, on the basis of *Neeman*, an income item exempt from income tax in the hands of the trust (specifically income from tax-exempt municipal bonds) would lose its tax-exempt character once distributed to a beneficiary notwithstanding statutory language to the contrary. In the present case, the Government relies on *Neeman* only for purposes of responding to taxpayer's constitutional argument, and its present position is in perfect harmony with the language and intended application of sections 661 and 662. These sections are plainly designed to deem certain distributions to a beneficiary to be distributions of income without regard to whether they in fact came from principal of the estate.

** Taxpayer ends her brief with a quote that

"Income tax, if I may be pardoned for saying so, is a tax on income" App. Br. 35.

The Government's response is:

"It is income to spend, to live on, to save. Is it not also income to tax, if Congress sees fit as it has, to tax it?"

Mahana v. United States, 88 F. Supp. 285, 288 (Ct. Cl.), cert. denied, 339 U.S. 978 (1950).

Taxpayer's constitutional thrust may be rejected for a second reason: the tax in issue may be viewed as within Congress' authority to lay and collect indirect, as distinct from direct taxes.

An indirect tax is imposed not on ownership of property, but on its receipt. See, e.g., *Scholey v. Rew*, 90 U.S. 331, 346-48 (1874); *Knowlton v. Moore*, 178 U.S. 41, 78-83 (1900); *Fernandez v. Wiener*, 326 U.S. 340, 352-55 (1945). This form of tax is imposed pursuant to Congress' "exhaustive" taxing authority under Article I, Section 8, Clause 1 of the U.S. Constitution. See *Brushaber v. Union Pacific R.R.*, 240 U.S. 1, 12 (1916). Unlike a direct tax, an indirect tax is not subject to the restrictions contained in Article I, Section 8, Clause 1, nor is it controlled by the Sixteenth Amendment, which was passed in order to overcome the constitutional restrictions affecting only direct taxation. See *Simmons v. United States*, *supra*, 308 F.2d at 165-66.

The distinction between a direct and an indirect tax is not always clear. See *First National Bank v. United States*, 420 F.2d 725, 732 (Ct. Cl.), *cert. denied*, 398 U.S. 950 (1970). However, the Fourth Circuit Court of Appeals has held that income tax imposed under the Code on the receipt of prizes and awards, see 26 U.S.C. § 74, is an indirect tax on the receipt of money, not on its ownership and thus this tax is not subject to the constitutional restrictions on direct taxation. *Simmons v. United States*, *supra*, 308 F.2d at 166-67. Similarly, the Tax Court has held that the income tax imposed on annuity payments, regardless of whether the recipient has recouped his investment, see 26 U.S.C. § 72, also is an indirect tax under the Constitution. *Waller v. Commissioner*, 39 T.C. 665, 678-79 (1963). In each instance, the Court found an indirect tax, not subject to Sixteenth Amendment restrictions, even though the tax is labelled

an income tax under the Code. See *Simmons v. United States*, *supra*, 308 F.2d at 166, n.21.

Here too, the tax imposed on taxpayer on her receipt of distributions, though termed an income tax, may properly be viewed as an indirect tax based on receipt of property rather than ownership. As such, it is not subject to Sixteenth Amendment restrictions, notwithstanding taxpayer's contrary suggestion. *Simmons v. United States*, *supra*, 308 F.2d at 166-67; *Waller v. Commissioner*, *supra*, 39 T.C. at 679.

Judge Conner's fourth opinion offers a third ground for rejecting taxpayer's constitutional claim. Under Sections 661-663 the Government imposes an income tax only on an estate's distributable net income. Under any view of the term "income", the Sixteenth Amendment plainly authorizes an income tax on such distributable net income. Beneficiaries such as the taxpayer, while they may have received principal, are simply being charged for a portion of this federal tax. Nothing in the Sixteenth Amendment suggests that Congress cannot deem as income sums actually received by beneficiaries where the United States is only collecting a total amount of tax equal to the estate's distributable net income. See JA-153.

Finally, the decision of the Court of Claims in *Harkness v. United States*, *supra*, 469 F.2d 310 suggests a fourth basis for rejecting taxpayer's Sixteenth Amendment claim. In *Harkness*, the Court of Claims was similarly faced with a constitutional challenge to the Government's authority to tax a beneficiary's receipt of principal distributions pursuant to section 662. The Court of Claims concluded that it was unnecessary to pass on this constitutional issue because the complaining taxpayer had had options available to her that would have permitted her to avoid being taxed on any principal under section 662. *Id.*, 469 F.2d at 319-20.

The Court of Claims' analysis applies with equal force in the case at bar. In negotiating her settlement, taxpayer arguably could have achieved a settlement whereby her second tier amounts would not have been subject to tax at all under section 662. Alternatively, she clearly could have arranged the settlement so as to insure that other beneficiaries would file amended tax returns and report and pay any additional income taxes on second tier distributions that might otherwise be charged to her by the Internal Revenue Service. In this case, she apparently exercised neither of those options. If, as a result of her failure, she is now liable for taxes on her 1965-1967 distributions, she can hardly blame the operation of Section 661-663 of the Code.

Taxpayer, of course, sees matters differently. She charges that the Government is guilty of "culpable neglect" because it failed to leap into the fray when she commenced her litigation against the estate in 1966. She believes that, at the outset, the Government should have assessed additional taxes or demanded extensions of the limitations period from everyone involved in her litigation and, in 1971, should have chased after the other beneficiaries who purportedly were obligated to pay taxes on the distributions otherwise chargeable to her. App. Br. 10-12. Taxpayer's position ignores four facts: (1) in 1966 there was reason to believe that if taxpayer were permitted to retain the 1965-1967 distributions after disposition of her lawsuit, the distribution would properly be treated as income distributions subject to tax regardless of the outcome of the suit;* (2) it would have required prescience for Government officials to determine in 1966 precisely who would eventually be "charged"

* If she prevailed in her suit, taxpayer would have been entitled to principal and income. JA-53. If she lost and were permitted to retain the distributions, they would have been income distributions given her under the will.

with the income distributions that taxpayer insisted were not chargeable to her and in what amounts (see JA-107); (3) despite representations that other beneficiaries were "charged" with taxpayer's distributions as part of the settlement, the settlement documents do not contain any such representations (JA-146; 419 F.Supp. at 73); and (4) taxpayer, not the Government, was a party to the settlement and it was she who struck the agreement she insists the Government should enforce.

In summary, there are not one but four separate answers to taxpayer's vague constitutional argument.* Taxpayer's argument, accordingly, should be rejected.

* But see *Harkness v. United States*, *supra*, 469 F.2d at 321-28 (Skelton, J. dissenting). Judge Skelton's lengthy dissent in *Harkness* sets forth his view that Section 662(a)(2) is unconstitutional insofar as it results in the imposition of a tax on principal distributions. In substance, the basis for Judge Skelton's conclusion devolves from an incorrect premise that "income" should be narrowly interpreted. Thus, he applies the definition of income used in *Eisner v. Macomber*, *supra*, 252 U.S. 189, not the more expansive definition given by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*, *supra*, 348 U.S. 426. The Judge does refer to the Supreme Court's more recent decision in *James v. United States*, *supra*, 366 U.S. 213, but quotes not the majority opinion, but the dissenting opinion of Mr. Justice Whittaker. Having applied this unduly narrow definition of the term "income", Judge Skelton then is able to conclude that the receipt of principal distributions, though an obvious accession to the taxpayer's wealth, is not the receipt of "income" properly the subject of a direct tax under the Sixteenth Amendment. Judge Skelton takes a similarly narrow view in dealing with the Government's claim that this tax is an indirect tax on the transfer of distributions, concluding that it had to be an income tax subject to the Sixteenth Amendment because the tax is called an income tax in the Code. Judge Skelton gives no mention to the two cases, cited in this brief, reaching a contrary result, *Simmons v. United States*, *supra*, 308 F.2d at 166-67; and *Waller v. Commissioner*, *supra*, 39 T.C. at 678-79. Finally, Judge Skelton states that the majority erred in stating that the constitutional issue need not be reached because the taxpayer had the means of avoiding hav-

[Footnote continued on following page]

CONCLUSION

By reason of the foregoing, the judgment of the District Court should be affirmed.

Respectfully submitted,

ROBERT B. FISKE, JR.,
*United States Attorney for the
Southern District of New York,
Attorney for Defendant-Appellee.*

WILLIAM G. BALLAINE,
PATRICK H. BARTH,
*Assistant United States Attorneys,
Of Counsel.*

ing her principal distributions taxed at all under section 662. Judge Skelton emphasizes that a beneficiary is not necessarily in a position to tell an estate how to make distributions. In our case, however, even Judge Skelton would have to concede that, in settling her dispute with the estate, taxpayer was very much in a position to have arranged matters in a way which would have avoided her present tax difficulties.

CA 77-6145

AFFIDAVIT OF MAILING

State of New York) ss
County of New York)

William G. Ballaine being duly sworn,
deposes and says that he is employed in the Office of the
United States Attorney for the Southern District of New York.

That on the

two copies
he served ~~xxxxxx~~ of the

2nd day of December 19 77
within Appellee Brief

by placing the same in a properly postpaid franked envelope addressed:

Seymour J. Kehlman
Blum, Haimoff, Gersen, Lipson & Szabad, Esquires
270 Madison Avenue
New York, New York 10016

And deponent further says he sealed the said envelope and placed the same in the mail chute drop for mailing in the United States Courthouse Annex, One St. Andrews Plaza, Borough of Manhattan, City of New York.

William D. Ballantyne

Sworn to before me this

2nd day of December, 19 77

PAULINE P. THOLA
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No. 31-4632381
Qualified in New York County
Commission Expires March 30, 1978